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Foreign Economic Trends and Their Implications for the United States

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KEY ECONOMIC INDICATORS

	1987	1988	1989	1990 proj.
Domestic Economy				
GDP-market prices (bil. pts)	36,159	40,129	44,985	49,874
GDP-market prices ($ mil.)	292,833	344,485	380,005	489,000
Real GDP growth (%)	5.6	5.2	4.9	4.1
GDP per capita ($)	7,541	6,835	9,708	12,442
Indust. Prod. Index (% chg.)	4.6	3.1	4.5	3.5
M_4 growth rate (% Dec./Dec.)	14.3	11.3	10.9	9.0
Bank of Spain Loan Rate (avg %)	16.0	11.3	14.0	14.5
Bank deposit rate (1-2 yr)(%)	9.1	9.2	9.7	10.0
Consumer Price Index (% chg.)	5.2	4.8	6.8	6.8
CPI (% chg. Dec./Dec.)	4.6	5.8	6.9	6.8
Govt. deficit (as % of GDP)	3.6	3.0	1.9	1.6
Employment and Wages				
Population (thous.)	38,832	38,988	39,144	39,301
Labor force (thous.)	14,407	14,633	14,819	15,016
Unemployment rate (%)	20.5	19.5	17.3	16.3
Nominal wage rate (% chg.)	8.3	8.0	7.9	8.5
Balance of Payments ($ mil.)				
Avg. Exch. rate (pts/$)	123.5	116.5	118.8	102.0
Exports, FOB	34,323	40,341	44,492	57,782
Imports, CIF	49,287	60,531	71,469	94,784
Merchandise balance	-14,964	-20,190	-26,977	-37,000
Net tourism	12,781	14,232	13,175	16,000
Current Account balance	-70	-3,690	-10,410	-17,600
Net foreign investment	8,319	9,129	14,615	16,000
Foreign exchange reserves	30,172	39,875	44,422	45,000
Foreign debt (govt. + priv.)	30,559	32,748	34,764	37,000
U.S.-Spain Trade (customs basis)				
Spanish Exports to U.S. ($ bil.)	2.8	3.2	3.3	3.5
-U.S. share of total exports (%)	8.1	7.9	7.4	6.0
-EC share of total exports (%)	63.7	65.6	66.8	69.0
Spanish Imports from U.S.($ bil)	4.1	5.4	6.5	8.5
-U.S. share of total imports (%)	8.3	8.9	9.0	9.0
-EC share of total imports (%)	54.5	56.8	57.1	58.0

Principal U.S. exports (1989): Aircraft & parts, computers, corn, soybeans, coal, machinery.

Principal U.S. imports (1989): Fuel, footwear, olives, tires, motor vehicle parts, cement, metals, wine.

Source: Official Spanish statistics and Embassy projections

July 1990

SUMMARY

Since joining the European Community (EC) in 1986, Spain has experienced the most consistently strong growth in the Community, at nearly double the EC's average. This economic expansion has been fueled by rapid growth in investment, both domestic and foreign, and it has gradually been reducing Spain's high rate of unemployment. Government officials view sustained economic growth as essential for further progress in lowering unemployment and ensuring that Spain catches up to EC levels of income and social welfare. Opportunities for additional investment abound, as Spain girds for competition within the EC single market. Spain's rapid growth has also created significant market opportunities for U.S. exporters, particularly in the nonagricultural area.

Near term prospects for sustained growth remain good, with official projections averaging 4.0 percent in real terms for the next several years. However, the heated pace of growth in domestic demand, averaging 7.7 percent in 1989, has contributed to an acceleration of inflation and a rapid increase in the trade deficit. The economic authorities, concerned that a worsening of these developments could cut short the economic expansion, implemented measures aimed at cooling the economy during 1989. These measures, which have been criticized for their excessive reliance on tight money and restrictions on credit growth, began to have a noticeable impact on growth by late 1989. A more conservative fiscal stance in 1990 will help complement monetary restraint. However, inflationary expectations and a weakening of the social consensus among government, business, and labor over economic policy have lead to more militant wage demands. The authorities are concerned that a wage/price spiral would further complicate the task of controlling inflation and maintaining Spanish competitiveness. Therefore, they have threatened to clamp down further if wages and prices do not moderate.

The current account deficit had burgeoned to 2.7 percent of GDP by 1989, largely under the force of a sustained import boom. Spanish officials look for the deficit to plateau at about 3.6 percent of GDP in 1990, as growth in internal demand moderates. However, financing has not yet been a problem. Long-term capital inflows, amounting to 4.6 percent of GDP in 1989, were dominated by foreign investment. Because of the strong capital surplus position, foreign reserves were up $4.5 billion to $44.4 billion at year-end. Except for some weakness induced by speculation in late 1989 and early 1990, the peseta remains one of the European Monetary System's strongest currencies. Although the peseta's strength puts a squeeze on competitiveness, it is an element in the government's anti-inflationary strategy aimed at long-term competitiveness.

STRONG ECONOMIC EXPANSION

The Spanish economy continued in a vigorous expansionary phase in 1989. The heated pace of domestic demand (consumption and investment) accelerated to 7.7 percent growth, which fueled a 4.9 percent rise in real gross domestic product. Growth in real GDP was only slightly more moderate than 1988's 5.2 percent and has now averaged 4.7 percent for the past four years. The official medium-term target is to maintain real growth at an average 4.0 percent per annum.

The prospects for above average growth over the long term are excellent, as the Spanish economy opens to greater international competition and as laws, regulations, and economic structures are brought up to EC norms. However, growth also brings problems. The strong pace of internal demand over the past few years has exerted inflationary pressure on prices, and the disparity between growth rates of internal demand and domestic production translates into a widening trade deficit.

Consumption: Strong employment growth, rising real wages, and increasing transfer payments caused private consumption to jump 5.5 percent in 1989. Similarly, an expansive fiscal policy boosted public consumption to 5.5 percent real growth. The policy objective is to slow both categories of consumption expenditure to 3.8 and 3.0 percent real growth, respectively, in 1990.

Inflation Accelerates: The boom in domestic demand has caused a setback in the battle to control inflation. Inflation continued to accelerate in 1989, when the consumer price index (CPI) rose 6.9 percent December/December. The problem is in nontradeable sectors, like services, where inflation exceeded 9.0 percent. Inflation, measured by industrial prices, is less serious, climbing from 3.0 percent in 1988 to 4.2 percent in 1989.

Given the risk of a wage/price spiral, the government has made reducing inflation a top economic priority. Inflationary expectations are already evident in more militant wage demands. Continued upward pressure on prices makes inflation likely to approach 7.0 percent in 1990, despite official projection of a 6.3 percent rise in the CPI.

Now that the peseta must be stabilized within the European Monetary System's (EMS) exchange rate mechanism, it is even more urgent for Spain to bring its inflation rate into line with that of other EMS participants. The differential between Spanish and average EMS inflation rates widened to 2.9 percentage points in 1989.

Economic Policy: Increasing inflation and the rapid deterioration of the trade/current account balances have caused concern over the long-term sustainability of the expansion. This concern induced the government to take several measures to tighten monetary and

fiscal policy in 1989 in order to slow demand growth. Growth in internal demand is projected to decelerate to 5.0 percent in 1990, and even further thereafter.

The emphasis in macroeconomic demand management policy has been placed on tightening monetary policy. A series of monetary tightening measures that began in late 1988 were reinforced in 1989 with restrictions on foreign capital inflows. However, they proved ineffective at slowing the stimulative pace of monetary growth, until restrictions on credit growth were also introduced in mid-1989. Economic indicators suggest that economic growth slowed substantially late in 1989. The restrictive money and credit provisions will be maintained through 1990 and will be complemented by a more moderate fiscal policy stance. Following the slowdown in demand which commenced in late 1989, economic growth is projected at 4.1 percent for 1990.

Investment has been the most dynamic component of demand growth, constituting one of the healthiest characteristics of the current expansion. Gross fixed capital formation was up 13.6 percent in real terms in 1989. Construction increased 13.1 percent, and investment in equipment was up 14 percent. The more than 50 percent cumulative real growth in investment over the last four years has permitted a major renovation of capital stock and demonstrates that the economy is being equipped for competition in the European single market. Moreover, this investment growth makes the deterioration in the trade balance less worrisome. A major part of import growth reflects the investment boom, which will bear fruit in greater production and export capacity.

Thanks to rising business profitability, the effort to tighten money and raise interest rates has had little impact yet on investment. Spanish business has increasingly relied on internally generated funds for investment. Nevertheless, the high growth will have a toll on productive investment, as will an inevitable squeezing of business margins in the face of high financing costs and rising labor costs. Investment is expected to slow to 9.3 percent real growth in 1990, with the deceleration being more pronounced in private investment. Investment in public works will remain strong, as Spain improves its infrastructure toward EC levels. Strong growth will also occur in investment in environmental and pollution control, an area where U.S. suppliers should be well-positioned to take a lead.

THE SUPPLY SIDE

Manufacturing was up 4.0 percent in real terms in 1989. Capital goods production began to decelerate, while consumer goods production accelerated considerably. Production of intermediate goods experienced sustained growth throughout the year. Capacity

utilization was high. Since business sentiment also remains high, there could be a lag before production responds to the expected slower demand growth.

Construction, up 13.1 percent in real terms in 1989, has been the most dynamic sector on the production side, and it will remain a key to sustaining economic growth. The biggest contributions to construction growth came from housing and public works, but there should be some deceleration in both in 1990.

Services grew 5.5 percent in real terms in 1989, with banking, insurance, communications, and retailing in the lead. Air and rail transport and hotel services turned in a less favorable performance, reflecting strikes and a downturn in tourism. Ideal summer weather in other European countries, transport strikes during vacation periods, safety concerns, and deteriorating price competitiveness weakened the tourism sector, which accounts for 9.3 percent of the economy. The number of foreign visitors declined 0.2 percent to 54 million, hotel bookings were off 11.3 percent, and foreign tourism receipts were down 1.0 percent. Tourism is expected to show slightly higher earnings in 1990 but will not gain in real terms.

Agriculture suffered a 4.0 percent drop in value added in 1989. A number of factors were responsible, notably: a severe drought, growing competition of agricultural imports from other EC countries, high interest rates, and lower support prices for some commodities. Conditions may continue to be difficult for much of the sector in 1990. Grain prices fell last year, despite lower production caused by drought. Feedgrain consumption is declining as feed compounders seek cheaper alternatives in animal feed rations. Although feed costs generally turned downward in 1989, Spanish livestock producers also had a difficult year as they faced increased imports from the EC.

The most important U.S.-Spain agricultural issue is the U.S.-EC Enlargement Agreement, which obligates Spain to import 2 million tons of corn and 300,000 tons of sorghum from non-EC sources annually from 1987 through 1990, most of which has come from the United States. Since the agreement expires this year, and EC grain policy is such that feedgrain imports are only possible under such special arrangements, the United States is seeking to negotiate an extension of the agreement.

Spain is an important market for U.S. soybeans, despite current restrictions on soybean oil consumption. Annual purchases of U.S. soybeans run close to $350 million. Under the terms of Spain's EC Accession Treaty, soybean import restrictions must be lifted in 1991. The vegetable oil policies that Spain enacts to replace the current restrictions will have a major impact on U.S. exports of soybeans to Spain.

EXTERNAL SECTOR

Imports Continue to Surge: Strong demand growth, increasing openness of the domestic market, and an erosion of Spanish competitiveness caused import growth to surge again in 1989. Imports of goods and services were up 17.5 percent in real terms, representing an acceleration from 14.1 percent in 1988. Growth is projected to moderate to 10.3 percent in 1990 and to settle down around 7.0 percent annual real growth over the long term. On a quantity (real) basis, merchandise imports were up 18.1 percent in 1989, about the same as 1988. The value of merchandise imports was up 20.2 percent, but growth is forecast to slow to 14 percent in 1990. Real growth in capital goods imports, nearly 27 percent of total merchandise imports, slowed to 20 percent in 1989 from 30 percent in 1988, while growth in consumer imports accelerated slightly to 19 percent.

Export performance is also affected by declining Spanish competitiveness and booming domestic demand, but international demand has been strong, particularly on the part of other EC countries whose share of Spanish exports is still growing. Greater productivity gains in export sectors, where there has been considerable investment and a squeezing of exporters' margins, may also be helping to offset the adverse effect of the peseta's appreciation, thereby sustaining moderate growth in merchandise exports. Spanish merchandise exports were up 12.2 percent in nominal value (7.4 percent in real terms) in 1989 and should increase about the same in 1990. The elimination of all remaining tariffs on Spanish industrial exports to EC and EFTA countries on July 1, 1989 also helps. However, a slump in export performance occurred in tourism, so real growth of goods and services exports slowed to 4.4 percent. Assuming tourism is steady in 1990, real growth in goods and services exports may rise to 6.7 percent.

Burgeoning Current Account Deficit: Even with the disparity in export and import growth rates narrowing, the trade deficit continues to widen. In 1989, the merchandise trade deficit (imports CIF/exports FOB) reached $27 billion, the world's third largest. Because of the decline in tourism and increasing tourism outflows, the traditional surplus on services trade shrank slightly. The current account deficit widened to $10.4 billion (balance-of-payments basis), or 2.7 percent of GDP.

With the merchandise trade deficit likely to climb to some $37 billion in 1990, the current account deficit will also increase to about $17.6 billion (3.6 percent of GDP). The inflow of foreign capital remains sufficient to finance these current account deficits for the present. Economic policy-makers expect to stem the deterioration of the current account by shifting to more export-led growth over the medium term. Import growth should decelerate along with slower growth in internal demand, and exports would be boosted by improved competitiveness and greater effort at commercial promotion.

Strong Capital Account: The capital account remains very healthy, with net long-term capital inflows amounting to $17.5 billion in 1989. Foreign investment showed a net balance of $14.6 billion. Although it may not grow as rapidly as in recent years, foreign investment will continue to dominate the capital account in 1990. Inbound investment of $24.8 billion in 1989 included $15 billion in portfolio investment, up 44 percent from 1988. Portfolio investment had been depressed by the 1987 stock market crash. Direct investment inflows climbed 16 percent to $7.2 billion. Net credit inflows shrank because the Bank of Spain imposed a 20-30 percent, nonremunerated, deposit requirement on foreign loans. The deposit requirement was instituted to discourage Spaniards from circumventing domestic monetary restraint by resorting to lower cost, foreign borrowing.

Foreign reserves increased $4.5 billion, reaching $44.4 billion at year-end 1989. Reserve levels would have been some $2.3 billion higher if not for intervention to resist speculation against the peseta during the last quarter.

Strong Peseta: The peseta appreciated 3.0 percent on a trade weighted basis during 1989, although it temporarily depreciated a bit against the dollar. The sustained appreciation of the peseta, coupled with higher Spanish inflation, has caused the real exchange rate to appreciate 21 percent with respect to other OECD currencies in 1985-89, thereby eroding Spanish commercial competitiveness. However, using producer prices, which may be more relevant for merchandise trade, the real appreciation with respect to EC countries over the same period was only 3.5 percent. Therefore, Spain's basic competitiveness vis-a-vis its major EC partners has not weakened seriously, while barriers to trade with EC countries have been lowered.

In June 1989, the Spanish Government committed the peseta to stabilization under the EMS exchange rate mechanism, with 6.0 percent bands on either side of bilateral parities. The currency quickly appreciated close to its limits. Speculation drove the peseta close to its central parity in October, but Bank of Spain intervention and market recognition that a strong peseta and tight money would remain elements of Spanish policy reversed this trend. When concerns over German monetary unification caused the mark to weaken in early 1990, the peseta again became one of the strongest currencies in the EMS. The peseta is likely to remain strong, despite the current account deficit, and it will be trading near its EMS limits while high interest rates persist and the Bank of Spain gradually dismantles restrictions on the inflow of foreign capital.

EMPLOYMENT, WAGES AND LABOR

Investment-led economic growth has provided dynamic job creation. Employment increased 4.1 percent in 1989, with 477,000 net new jobs, and unemployment declined to 17.3 percent. Most of the unemployed either received unemployment compensation, or represent a second or third wage-earner in a family where someone else has income. As the momentum of the economic expansion slows in 1990, job creation will slow as well. Official projections include a 2.5 percent increase in employment, and a further decline in the unemployment rate to 16.3 percent. Most new hiring is in the form of temporary labor contracts for up to three years. These were introduced as a labor market liberalization in 1984 and do not commit an employer to provide job security. Some 25 percent of employees are now under such contracts.

Strike activity has declined, despite policy clashes between labor and business, partly because of business' willingness to raise wages rather than suffer loss of production during a boom. The number of strikes was down 23 percent in 1989, the number of workers involved dropped 69 percent, and work time lost declined 49 percent to 59 million hours.

Nominal wages rose 8.0 percent in 1989, but inflation meant real wages rose only about 1 percent, roughly matching productivity gains. Maintaining that workers have not shared adequately in the boom, labor has sought 8-9 percent increases in 1990, with guarantees of 2.0 percent real wage gains. Settlements have clustered around 8.5 percent increases, plus catch-up adjustments for unexpectedly strong inflation last year. However, the government has threatened to respond to high wage settlements with tougher monetary and fiscal measures, since a wage-price spiral would weaken Spanish competitiveness without helping real wages.

The government has launched a "social dialogue" with labor and business in hopes of agreeing on measures which would maintain competitiveness and restrain inflation. However, while labor is willing to talk with the government, it has refused to have a tripartite dialogue including business and has been reluctant to consider any agreement that would single out wages for moderation. A few agreements have been reached between labor and government, notably one providing for individual labor contracts to be vetted by union representatives to ensure compliance with labor law. Business spokesmen have vowed to fight this provision.

MONETARY AND FISCAL

Fiscal: Government spending helped fuel the expansion in demand, with a 15.5 percent nominal rise in nonfinancial spending in 1989. Economic growth and improved tax compliance continued to drive revenues, which rose 20.4 percent and allowed the central government cash deficit to drop to 1.9 percent of GDP.

Although government spending and taxation relative to GDP are less than in most Western European countries, Spain has registered the most rapid growth in those areas among OECD countries over the past decade. Political demands for social welfare spending at levels comparable to other EC members and the need to improve public infrastructure make it difficult to implement the greater fiscal restraint needed to control inflation and slow the growth in the current account deficit. Nevertheless, the government recognizes the urgency of redressing macroeconomic imbalances before they affect confidence levels, especially now that increasing EC integration leaves less margin to maneuver with economic policies. Consequently, fiscal policy will take a more cautious stance beginning in 1990, with expenditure growth to be kept at or below overall growth of the economy. The central government budget deficit is expected to fall to 1.6 percent of GDP in 1990 and is supposed to be eliminated in 1992.

The government has also recently indicated that tax pressure should be stabilized around current levels relative to GDP. An income tax reform currently under consideration would eliminate the marriage tax penalty (as required by a court ruling), encourage savings, and rationalize tax deductions. In view of the need for tax harmonization among EC countries, the reform is likely to be accompanied by a shift in the tax structure toward greater reliance on indirect taxation.

Monetary Restraint: Initial efforts to slow domestic demand in 1989 relied mostly on monetary policy, but even with a sharp rise in interest rates and restrictions on foreign capital inflows, monetary restraint remained elusive. Only after the Bank of Spain imposed a 13 percent limit on the growth of bank credit to the private sector did credit growth moderate, leading to 12.6 percent annual growth in M4, the target monetary aggregate. (M4 is defined as the sum of currency, time deposits, savings deposits, Treasury bills, private liquid assets, other liquid assets, and credit.)

For 1990, the Bank of Spain has established a 6-9 percent target growth range for M4. Controls on credit growth have been extended, with a 10 percent limit for the year. These controls were strongly criticized as a step backward in economic liberalization. They have tended to accelerate disintermediation; growth in credit has exceeded the target rate; and M4 growth was at its ceiling during first quarter 1990. The monetary authorities consider credit controls as only a temporary expedient, while the government seeks to improve fiscal restraint and encourage wage moderation.

IMPLICATIONS FOR U.S. BUSINESS

Continued Spanish growth has generated excellent opportunities for American exporters. In 1989, U.S. exports to Spain were up 13.8 percent, according to U.S. figures. Manufactures rose 26 percent. Major categories were aircraft, computers, chemicals, coal, soybeans, building materials, medical/laboratory instruments, and telecommunications equipment. Significant demand

exists for a broad range of American products and services. The favorable combination of factors contributing to this -- Spanish economic growth, a relatively strong local currency, and import liberalization -- are expected to continue over the medium term. The following sectors have especially good growth prospects:

-- Computers and peripherals
-- Telecommunications equipment and services
-- Medical equipment
-- Analytical and scientific instruments
-- Building materials
-- Sporting goods and recreation equipment
-- Pollution control equipment
-- Security and safety equipment
-- Food processing and packaging machinery
-- Hotel and restaurant equipment

For most new-to-market American companies, identification of a Spanish importer/distributor is the most realistic market entry method. Local government regulations on distributorship agreements are straightforward. Regarding distribution channels, this market can best be described as a series of regional markets joined to two major hubs -- Madrid and Barcelona. These two cities contain the vast majority of agents, distributors, corporate headquarters, and government entities that comprise the economic power blocks of Spain. The U.S. Department of Commerce Agent/Distributor Service and FCS Spain's Gold Key Service for visiting American business representatives are ideal tools in a company's search for qualified representation.

Spain's liberalization of foreign investment legislation since 1986, its promising economic performance, and its position within the EC have attracted foreign investment beyond all expectation for the past several years. This investment and the strong real growth in domestic fixed capital formation demonstrate that the Spanish economy is equipping for a more competitive European market. There has been some local concern that the opening of Eastern Europe might divert investor interest from Spain, particularly on the part of German investment, which represented about 6.7 percent of recorded direct investment in 1989. Still, with Spain becoming a part of the EC single market, outstanding opportunities exist for joint ventures and new distribution arrangements that will improve the competitiveness of Spanish firms for the 1990s.

Historically, the United States has been a major source of foreign investment in Spain, but the U.S. share of reported new investment, which was 4.1 percent in 1989, has declined as investment surges in from other countries, particularly from the EC. Nevertheless, projects announced by U.S. multinationals, such as Dupont, General Electric, and Anheuser Busch, remain significant elements of the foreign investment picture. The outlook for U.S. investment in Spain will improve in 1991, when a recently signed U.S.-Spain tax treaty is expected to enter into force.

UPCOMING PROMOTIONAL EVENTS

To take advantage of business opportunities, FCS Spain has planned the following promotional events during the second half of 1990 and in 1991:

1990

Matchmaker Trade Delegation (Boating)
October 8-12, Barcelona and Genoa

USA Pavilion at SIMO (Computers, peripherals, software, and office equipment)
November 16-23, Madrid

1991

USA Pavilion at FITUR (Tourism to U.S.)
January 23-27, Madrid

USA Pavilion at Hispack 91 (Packing and packaging equipment)
January 28-February 1, Barcelona

Computer and Information Services Trade Mission
March (date to be confirmed), Madrid

Matchmaker Trade Delegation (Sporting goods and apparel)
March 12-15, Madrid and Barcelona

Avionics Trade Mission
September, Madrid

USA Pavilion at SIMO (Computers, peripherals, software, and office equipment)
November, Madrid

Additional information on these events may be obtained from FCS Madrid by phone: (011-34/1) 577-4000, or by FAX: (011-34/1) 575-8655.

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